Buffalo Law Review

Volume 26 | Number 2 Article 5

4-1-1977

The Continued Vaildity of the Supreme Court's Broad Approach to Income in James v. United States

William B. Barker

Follow this and additional works at: https://digitalcommons.law.buffalo.edu/buffalolawreview

Part of the Taxation-Federal Commons

Recommended Citation
William B. Barker, *The Continued Vaildity of the Supreme Court's Broad Approach to Income in James v. United States*, 26 Buff. L. Rev. 389 (1977).
Available at: https://digitalcommons.law.buffalo.edu/buffalolawreview/vol26/iss2/5

This Comment is brought to you for free and open access by the Law Journals at Digital Commons @ University at Buffalo School of Law. It has been accepted for inclusion in Buffalo Law Review by an authorized editor of Digital Commons @ University at Buffalo School of Law. For more information, please contact lawscholar@buffalo.edu.

THE CONTINUED VALIDITY OF THE SUPREME COURT'S BROAD APPROACH TO INCOME IN JAMES V. UNITED STATES

INTRODUCTION

Although federal taxation has always been governed by a comprehensive code, tax principles developed by the courts supplement or even dominate its provisions. Basic to federal income taxation is section 61 of the Internal Revenue Code, which states, "gross income means all income from whatever source derived."[1] The courts have utilized several different theories to define what constitutes income, but these theories have not been carefully applied. The purpose of this Comment is to analyze an important income tax theory developed by the Supreme Court in *James v. United States*,[2] and to show that proper explication of the broad theory of income adopted in *James* may provide a consistent judicial approach to income.

I. BEFORE JAMES: THE CLAIM OF RIGHT DOCTRINE

Narrowly perceived, *James* is merely the fullest development of a tax theory known as the claim of right doctrine,[3] first adopted by the Court in *North American Oil Consolidated v. Burnet*.[4] In that case the right to certain revenue had been the subject of a legal dispute between the taxpayer and the federal government. By the time the case reached the Supreme Court, the money had been awarded to the taxpayer. The sole question before the Supreme Court was *when* the taxpayer was required to include the monies in his gross income. The Court considered three alternatives: Year *1*, when the monies were being held by a receiver pending the trial court's resolution of the conflict; Year *2*, when, after the trial court found in favor of the taxpayer, he demanded and acquired the monies from the receiver; and Year *3*, when the trial court's decree became final after the period for appeal from the appellate court's decision had passed.

1. I.R.C. § 61.
2. 366 U.S. 213 (1961).
3. For a good discussion of the claim of right doctrine at its apex, see Webster, *The Claim of Right Doctrine: 1954 Version*, 10 TAX L. REV. 381 (1955).
4. 286 U.S. 417 (1932).

The Court used a two-part test. First, it considered whether the taxpayer had made a "claim of right" to the money. It was not clear if the Court meant to inquire whether the taxpayer had a colorable legal claim to the money, or merely whether he had exercised control over the money.[5] On the facts of the case either test was met. Second, the Court looked to whether, after the taxpayer had received the money, his use of it was subject to substantial restrictions.[6] Fulfillment of the second requirement would belie the assumption of gain and exempt the funds from income taxation. The Court said:

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.[7]

The tax, therefore, was due in Year 2, when the taxpayer first became entitled to the money and in fact actually received it.

It has been asserted that the doctrine developed in *North American* has little to do with the question of what is income, but is useful only for ascertaining the year to which income should be assigned.[8] Such an interpretation would make inclusion of the monies in one year await determination of the ownership of the funds.[9] Rather, *North American* rejected this possibility[10] and established the proposition that the taxpayer has income in Year 2 whether or not his claim to the money is eventually upheld.

In *Commissioner v. Wilcox*,[11] the Supreme Court was presented with the problem of whether the claim of right doctrine

5. After *North American*, but before the Supreme Court's next treatment of the problem, Judge Learned Hand, in National City Bank of New York v. Helvering, 98 F.2d 93, 96 (2d Cir. 1938), defined claim of right in terms of possession of money and individual intent to control it, regardless of the legal validity of the possessor's claims.

6. Though the Court did not give any examples of substantial restrictions, the paradigm is a bailment. *See also* I.R.C. § 83, which exempts the receipt of property from a corporation from income taxation when received with substantial restrictions.

7. 286 U.S. at 424.

8. *See* James v. United States, 366 U.S. at 216 n.7 (Court commenting upon the Commissioner's argument). *See also* Webster, *supra* note 3, at 384-85.

9. *See* Healy v. Commissioner, 345 U.S. 278 (1953), which required the taxpayer to include money in income even though his claim was later found to be mistaken and he was required to repay it.

10. The Court concluded, "[i]f in 1922 the Government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year." 286 U.S. at 424.

11. 327 U.S. 404 (1946).

required an embezzler to include his wrongful appropriations in his gross income. The Court examined *North American* and again determined that a taxpayer must have a "claim of right" to money before it becomes income to him. The facts of *Wilcox* forced the Court to define more clearly the relationship that gives rise to tax liability. The Court held that the taxpayer would be liable only if he had taken the money under a colorable legal claim.

Focusing on the relationships of the embezzler and of his victim to the funds, the Court concluded that there was no gain to the embezzler. To be income, money must be received without "a definite, unconditional obligation to repay or return that which would otherwise constitute a gain."[12] Only a legal obligation meets the requirements of this exacting test. The "claim of right" doctrine was thus narrowed by the Court to a "claim of law" rule. If ownership of money was claimed under a bona fide though questionable point of law, then the money would be taxable. Since the embezzler's firm obligation to repay was discernible from the moment he took the money, the money would not be taxable even if he never repaid it.[13] Hence *Wilcox* stands for the proposition that a taxpayer's income is measured by his legal responsibilities, not by practical economic realities.[14]

It was not long before the Supreme Court had to deal with the income tax status of other wrongful gains. In *Rutkin v. United States*,[15] the government sought to tax gain derived from extortion. *Wilcox* was distinguished on the basis of common law property principles: while an embezzler has no property interest in embezzled funds because his victim is ignorant of the transaction, an extortionist has a voidable property interest in his gain because his victim is an active party to the transfer of the money.[16] A strict reliance on the *Wilcox* rule would have freed both the extortionist and the embezzler from taxation, for both have an unqualified

12. *Id.* at 408.

13. The Court did not indicate whether the money would be income after the statute of limitations had run.

14. *See* United States v. Lewis, 340 U.S. 590 (1951). A law-abiding taxpayer had received income under a mistaken claim of right. The Court emphasized that the taxpayer "had at all times claimed and used the full $22,000 unconditionally as his own" until the discovery of the mistake. *Id.* at 591. The Court found that the taxpayer had correctly included the money as income in the year he received it. Certainly the average embezzler enjoys his gains no less than did Lewis before his obligation was discovered. The *Wilcox* approach permits the wrongdoer to enjoy his gain without tax liability, yet the honest taxpayer must pay.

15. 343 U.S. 130 (1952).

16. 366 U.S. at 216.

obligation to return what they illegally obtained. *Rutkin*, however, saw as the determinative factor not legal right to money, but the ability of the taxpayer to divert it to his purposes, and concluded that real economic gain to the taxpayer should be taxed. *Rutkin* failed to notice that an embezzler also has real economic gain.

Wilcox had excluded from taxation money in the taxpayer's possession to which he had no legal claim. *Rutkin*, however, applied a more expansive view of what constitutes income. Following the lead of Judge Learned Hand,[17] the Court found that dominion over money may result in taxation of the money under the claim of right doctrine.[18] The Court stressed that money "constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it."[19] While the Court did not overrule *Wilcox*, by emphasizing practical, economic realities the Court foreshadowed the demise of the *Wilcox* approach in *James v. United States.*

II. JAMES V. UNITED STATES

Eugene C. James was convicted in United States District Court of willfully attempting to evade federal income tax by failing to include embezzled money as income in the year in which it was misappropriated.[20] The conviction was affirmed by the Seventh Circuit.[21] *James* confronted the question of whether *Wilcox* would continue to shield the embezzler from income taxation on his wrongful gain. *James* in effect overruled *Wilcox*,[22] holding that

---

17. *See* note 5 *supra.*

18. Perhaps the central problem in *Wilcox* was the Court's failure to distinguish "right" from "law," a distinction that was apparent to Judge Learned Hand. *See* note 5 *supra.* Right to money can be defined as the intention of the taker of the money to keep it, coupled with the fact that possession of the money will usually permit him to use it as he pleases. His intentions and his control are not directly relevant to his legal claim to the money. The *Wilcox* rationale says in one breath that not only does the embezzler have no gain, but also that the victim has no loss unless the embezzler's obligation is worthless.

19. 343 U.S. at 137.

20. *See* I.R.C. § 7201.

21. 273 F.2d 5 (7th Cir. 1959).

22. Six justices agreed that the *Wilcox* case should be overruled. See the opinion written by Chief Justice Warren and joined by Justices Brennan and Stewart. 366 U.S. at 213. In concurring opinions on the issue of taxability, Justices Harlan and Frankfurter agreed with so much of the Court's opinion "as dispatches *Wilcox* to a final demise." *Id.* at 241. Justice Clark also joined in overruling the *Wilcox* case. *Id.* at 241.

The other major issue was whether James' evasion of tax was willful, since in the year he failed to pay tax on his embezzled funds *Wilcox* was still ruling precedent. On funds subject to a legal obligation of repayment are immune from taxation only if the obligation has been recognized. Quoting from *North American,* the Court adopted the following approach to what constitutes income:

> When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to its disposition, "he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."[23]

The first part of the *James* test was whether the taxpayer actually had gain from his receipt or control of funds. If this prerequisite were met, then the funds would be taxable unless there had been a "consensual recognition of an obligation to repay."

The Court thus adopted a broad view of what constitutes income. It relied on expansive definitions of income previously stated in *Rutkin*[24] and in two cases not involving funds misappropriated by taxpayers.[25] The *James* Court abandoned the claim of right doctrine developed in *North American,* because this doctrine had been interpreted in *Wilcox* as a limitation on the taxation of money received.[26] *James* was, however, much more than a simple refutation of *Wilcox.* The Court argued that Congress' definition of income had been read expansively by the courts, and that the claim of right doctrine should not be applied to exclude from

---

this issue, the plurality dismissed, deciding that the tax consequences of their decision would be given only prospective effect. *Id.* at 221-22. The Supreme Court reversed and remanded the case to the district court with directions to dismiss the indictment. *Id.* at 222.

23. 366 U.S. at 219 (quoting North American Oil Consolidated v. Burnet, 286 U.S. at 424).

24. *See* text accompanying notes 15-16 *supra.*

25. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955); Corliss v. Bowers, 281 U.S. 376 (1930). *Glenshaw Glass* defined income as "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." 348 U.S. at 431. *Corliss* saw as the significant attribute of gain "actual command over the property taxed—the actual benefit for which the tax is paid." 281 U.S. at 378.

26. The Court specifically declined to answer the Commissioner's argument that the claim of right doctrine, properly interpreted, decided only *when* an item should be included in income, not *what* should be included, and, hence, could not prevent the inclusion of the embezzler's gain. 366 U.S. at 216 n.7. However, the need for an explanation was obviated by the Court's expansion of its approach to income.

taxation actual economic gain.[27] In other words, real gain will be presumed to be income, and the legality or illegality of the gain will be of no import.

The Court did except bona fide, consensual loans from income taxation. The limits of this exception, though, were not immediately clear. Consent might mean the assent of either party to the temporary transfer of funds,[28] that is, recognition by either the creditor or the debtor of the obligation to repay. *James,* however, must have intended consent to be more than recognition by the embezzler of his obligation to repay the money, for many embezzlers plan at the time they take money to return it eventually.[29] Nor, under *James,* could the consent of the former owner alone be sufficient. First, the victim of an embezzlement was unaware of the transfer, and thus could not have consented to it. Second, most victims insist on the embezzler's obligation to repay; to allow assertion of this obligation to bar taxation would be to resurrect the *Wilcox* rule, a result contrary to the clear holding of *James.*

The only workable definition of consent in the *James* context is that it requires (1) knowledge by the one whose money is transferred that it has been borrowed, and (2) willingness of the recipient to repay it. "Consent" has been defined as any "concurrence of wills,"[30] or an "agreement; the act or result of coming into harmony or accord."[31] Reciprocity is absent in wrongful appropriations, but a bona fide loan embodies it—the lender parts with his money with the understanding that the borrower will re-

---

27. *See* text accompanying notes 7 & 23 *supra.* Of some importance in understanding the Court's approach may be the Court's change in *North American's* definition of income as "receives earnings" to "acquires earnings." In tax law, receipt often means actual physical possession. Hence, courts have felt the need for the doctrine of constructive receipt, which imposes taxation on items which the taxpayer has the right to receive but does not yet actually possess. "Acquire" has no such limited meaning in tax theory. Its meaning, "[t]o gain by any means," WEBSTER'S NEW INTERNATIONAL DICTIONARY 23 (2d ed.), expresses the Court's decision to apply a broad test for income. *See* notes 24-25 *supra* & accompanying text.

28. BLACK'S LAW DICTIONARY 377 (4th ed. 1968).

29. *See* Moore v. United States, 412 F.2d 974 (5th Cir. 1969). In an elaborate swindle, the taxpayer fraudulently obtained loans from financial institutions using false notes as security. The trial court found that the taxpayer had at all times intended to see that the banks were repaid, but the court of appeals concluded that his consent by itself was insufficient to meet the requirement of consensual recognition. The lenders would not have made the loans had they known the taxpayer had misrepresented his security, and they did not consent to the transactions that in fact occurred. Therefore, the Fifth Circuit concluded that the loans were taxable as income to the taxpayer.

30. BLACK'S LAW DICTIONARY 377 (4th ed. 1968).

31. *Id.*

pay; the borrower obtains the money only upon his agreement that the money will be repaid. *James* recognized that while this consensual standard "brings wrongful appropriations within the broad sweep of 'gross income,' it excludes loans."[32]

The exception of loans from gross income has been a fundamental proposition of income tax law from its inception.[33] The rule has been justified by its necessity for business and by the presumption that loans will be repaid.[34] Nonetheless, the proceeds of a loan are in actuality gain, and would be taxed if this policy exception were not made. There can be no doubt that a loan improves a borrower's economic position, because it permits him now to do or acquire something that he would not otherwise be able to do or acquire until later. Some claim that since the gain is temporary, it really is not gain. A fundamental premise of the cash basis method of accounting for taxation, however, is that a taxpayer must account for his receipts even though they are offset by liabilities that the taxpayer must honor later. A loan, in effect, is a transfer of the right to future payments in exchange for cash; by obtaining a loan, a taxpayer has anticipated future income.[35]

This analysis has generally been accepted by the courts, but decisions have split on two points. The first is at which time the parties must consent to the transfer and future repayment of money in order to exclude the recipient's gain from income taxation. The second is whether the courts should look behind the formal aspects of a transaction to the subjective intentions of the parties in order to determine whether consensual recognition was present.

III. Consensual Recognition

A. *Timing*

The lower courts have differed in their treatment of the effect of consensual recognition given not at the time of the initial transaction, but sometime thereafter. The situation, though having

32. James v. United States, 366 U.S. at 219.

33. *See generally* 1 Mertens, Law of Federal Income Taxation § 5.12 (1974 rev. ed.).

34. Of course, not all loans are repaid. Tax law does not require a loan to be included in gross income until the debt has been forgiven by the lender (when cancellation of the debt is not a gift), or until the debt has become unenforceable because the statute of limitations has run. *See generally* 5 Mertens, *supra* note 33, § 2838 (1975 rev. ed.).

35. For a discussion of the relation between "sale" and "loan," see Joyce & Del Cotto, *The AB (ABC) and BA Transactions: An Economic and Tax Analysis of Reserved and Carved Out Income Interests,* 31 Tax L. Rev. 121, 172-73 n.176 (1976).

many variations, is basically this: *A* embezzles, steals, or mistakenly obtains monies from *V* (the victim); sometime thereafter, *V* discovers the problem, *A* and *V* recognize the debt, and both agree on terms for repayment.

The Commissioner of the Internal Revenue Service has invariably analyzed this scenario according to common accounting principles. If the initial transfer of money took place without the knowledge and consent of both parties, the recipient will be required to include the money in his gross income. If the recipient is a cash-basis taxpayer, then he will not be permitted to offset income with a subsequent promise to repay the monies.[36] Only actual repayment in the year of the initial transaction will eliminate tax liability.

The Commissioner's view has received inconsistent treatment in the courts. It is clear that his view is followed if the agreement to repay is entered into after the taxable year of receipt.[37] There is conflict among the courts, however, as to the effect of an agreement entered into in the same year as the initial transaction.

In *United States v. Merrill*,[38] decided before *James*, the Ninth Circuit presented one side of the debate. The taxpayer received funds under a mistaken claim of right, recognized his mistake, and made provision to repay the funds, all in the same taxable year—1940. He repaid the money in 1943. The court ruled that the taxpayer's renunciation of his claim to the money, if made in the same year as his receipt of the money, was sufficient to negate the presumption that the money was income to him.

In *Mais v. Commissioner*,[39] decided after *James*, the Tax Court distinguished *Merrill*. Within one taxable year the taxpayer had embezzled funds and the parties had agreed to terms for repayment. To the taxpayer's reliance on *Merrill*, the court replied:

36. Under the cash basis method of accounting, income and receipts are reported in the year received, and deductions and credits are taken in the year payments justifying them are made. I.R.C. §§ 451 (a), 461 (a). *See generally* J. CHOMMIE, FEDERAL INCOME TAXATION § 82 (1973). A taxpayer on the accrual method may offset income with an agreement to repay since the liability is fixed. Whitaker v. Commissioner, 259 F.2d 379, 382 (5th Cir. 1958).

37. *E.g.*, Norman v. Commissioner, 407 F.2d 1337 (3d Cir. 1969); United States v. Merrill, 211 F.2d 297 (9th Cir. 1954). In *Norman*, the taxpayer embezzled funds from 1958 through 1962. When he was apprehended, the taxpayer agreed to repay the funds over a five-year period. The Third Circuit concluded that the monies would be income in the year taxpayer received them, for to hold otherwise would violate the integrity of the taxable year.

38. 211 F.2d 297 (9th Cir. 1954).

39. 51 T.C. 494 (1968).

> We interpret the *James* case as meaning that any taxpayer who acquires property under circumstances which do not permit the conclusion that the property was received with a consensual recognition . . . is in receipt of taxable income. Certainly in the case of an embezzlement it cannot be considered that the funds are obtained by the embezzler under a consensual recognition of an obligation to repay; indeed, the victim of the embezzlement is unaware of the diversion of his property.[40]

The court believed that the honest taxpayer in *Merrill* had the tacit consent of the person whose money he had received.[41]

Six years later the Tax Court reversed itself. In *Buff v. Commissioner*,[42] the taxpayer embezzled funds from his employer, was discovered, and immediately agreed to repay—all in the same year. The amounts remained unpaid seven years later. The Tax Court followed *Merrill* and concluded that the sums were not income to the taxpayer in the year of their receipt.

In its appeal of the *Buff* case to the Second Circuit, the government presented two major arguments. The first argument, following *Mais*, was that true consensual recognition can occur only when funds are transferred;[43] the second was that the agreement to repay was only a sham.[44] The Second Circuit declined to base its decision on the first argument, for it concluded that *James* simply had not addressed the question of when consensual recognition must be given if the recipient of money is to escape taxation.[45] The *Buff* court was able to avoid the question by holding that the transaction was a sham: that is, the embezzler had made no payment or offsetting promise of any value.[46] *Buff* explicitly left open the question of whether embezzled funds may be ex-

---

40. *Id.* at 498.

41. The Supreme Court had not found this sufficient in United States v. Lewis, 340 U.S. 590 (1951). *See* note 14 *supra*.

42. 496 F.2d 847 (2d Cir. 1974), *rev'g* 58 T.C. 224 (1972).

43. *See* text accompanying notes 39-40 *supra*.

44. 496 F.2d at 848.

45. *Id.* at 849.

46. The decision rested on the absence of consensual recognition at the time of the agreement to repay. The court looked to objective circumstances at the time of the agreement, not to the embezzler's subsequent failure to repay. When the taxpayer made the agreement, his resources and prospects were clearly inadequate to cover the amount owed. Therefore, the court found that the embezzler's intent to repay was not, in fact, bona fide.

cluded from the embezzler's gross income if, later in the same year in which he took the funds, he in fact agrees to repay them.[47]

In the last major treatment of this problem, the Seventh Circuit, in *Quinn v. Commissioner*,[48] decided in favor of the Commissioner.[49] Concluding that a taxpayer has income unless consensual recognition is present at the time of receipt, the court found that *Merrill* was "incorrectly decided" and would not be applied in the Seventh Circuit.

The Tax Court in *Quinn*[50] indicated indirectly another reason why consensual recognition given after money has been transferred should never permit the recipient to escape taxation. In a single year, the taxpayer withdrew money without authorization from the firm which employed him, admitted his debt, and made provision for its repayment. There was no question of the taxpayer's honest commitment to repay, for his obligation was secured by his interest in a land trust. For this reason, the Tax Court found *Buff* distinguishable. As in *Buff*, though, the court did not rely on the mere existence of an agreement, but looked to the true intent of the parties. The court noted that it was against state law for the victim, a corporation, to have loaned money to the taxpayer, its principal shareholder, and that, after the taking, the victim had no alternative but to accept the taxpayer's note. Since the corporation's consent was not truly voluntary, the court concluded that the money was income to the recipient. The sense of the court's opinion is that consent must be active, not just passive acquiescence to a *fait accomplit*. Without doubt, consensual recognition by the victim after the fact is always less than truly volun-

---

47. A related problem is whether the recipient of money must include it in his income when consensual recognition is present at the time of the initial transaction, but when the amount of his obligation is not fixed until later. In Gaddy v. Commissioner, 38 T.C. 943 (1962), *modified*, 344 F.2d 460 (5th Cir. 1965), the taxpayer received payments which, under the terms of a contract, were subsequently determined to be returnable as overcharges. The court found that both the taxpayer and the party he contracted with had always recognized the taxpayer's legal obligation to honor the contract, and since the amount due was made definite in the same taxable year, the overpayments were not income to the taxpayer. *Gaddy* dealt with a cash-basis taxpayer. *Accord*, Bates Motor Transp. Lines, Inc. v. Commissioner, 17 T.C. 151 (1951), *aff'd*, 200 F.2d 20 (7th Cir. 1952) (accrual-method taxpayer).

48. 524 F.2d 617 (7th Cir. 1975). *See also* Rappaport v. United States, 419 F. Supp. 1236 (N.D. Ill. 1976).

49. *See* text accompanying notes 36-37 *supra*.

50. 62 T.C. 223 (1974), *aff'd*, 524 F.2d 617 (7th Cir. 1975).

tary and should not be used to prevent taxation. The entire transaction is in the nature of a forced loan.[51]

The Second Circuit in *Gilbert v. Commissioner* has recently added a new wrinkle to this problem.[52] The taxpayer, president of a corporation, took money with the knowledge of some of the corporation's officers and directors, and used it to protect stock options that he held for the benefit of the corporation. Immediately thereafter, the president sought ratification of the transaction, but this was refused. He therefore assigned to the corporation personal assets sufficient to secure his obligation. The Tax Court concluded that since the victim corporation had not formally consented to the transfer when it first occurred, the money was income to the taxpayer.[53]

The Second Circuit reversed, finding there had been express consensual recognition of an obligation to repay, because "the secretary of the corporation, who signed the checks, the officers and directors to whom Gilbert gave contemporaneous notification, and Gilbert himself were all aware that the transaction was in the nature of a loan."[54] Furthermore, on several previous occasions the taxpayer had withdrawn money for corporate purposes without authorization and in each case his actions had been approved. The implication of the Second Circuit's holding in *Gilbert* is that a taxpayer is not taxable on money he takes from a corporation, even though the corporation does not ratify his action, if his expectation of the corporation's consent is reasonable and both his intent and ability to repay are established.

B. *Piercing the Form of a Transaction*

The courts have also asked whether a transaction that looks like a loan is, in fact, a loan. In determining whether consensual

---

51. Certainly the question can be asked why a forced loan should not be treated as a loan. One answer is that the government does not wish to encourage wrongful appropriations by permitting wrongdoers to take advantage of the favorable tax treatment afforded to bona fide loans. More important, however, the question of what constitutes income initially depends on what is fair to the taxpayer. Clearly, one who wrongfully takes money cannot claim it is unfair to tax him on his gain. If he subsequently repays the money, he may be entitled to a deduction. On the other hand, fairness to the victim should be taken into consideration when the government intends to enforce its claim for a tax deficiency. *See* note 65 *infra*.

52. Gilbert v. Commissioner, No. 76-4170 (2d Cir. Apr. 4, 1977), *rev'g* Edward M. Gilbert, 1976 T.C.M. (P-H) ¶ 76,104.

53. Edward M. Gilbert, 1976 T.C.M. (P-H) ¶ 76,104.

54. Gilbert v. Commissioner, No. 76-4170, slip op. at 7.

recognition is present, the majority of courts, relying on the *James* objective of recognizing economic realities, hold that the substance of a transaction determines income tax liability. These courts require that both parties intend to establish a debt which will be repaid. Otherwise, the proceeds will be taxable to the recipient in the year he receives them. The courts have allowed the parties' subjective intent to be established by objective circumstances surrounding the transaction.[55]

This view was adopted in *United States v. Rochelle.*[56] The taxpayer had fraudulently induced others to lend him money, and the trial court found that he never had any intention of repaying the loans. The Fifth Circuit found this sufficient grounds to determine that the *James* test of consensual recognition had not been met and held the amounts received to be income to the taxpayer, although the lenders had treated and continued to treat the transactions as loans.

In *Fairchild v. Commissioner,*[57] the taxpayer had borrowed large sums of money over many years to finance a business venture. He did not repay any of the money. Though actual fraud was not found, the Tax Court, employing an analysis similar to that later used in *Buff,* stressed that the taxpayer had borrowed money repeatedly despite his inability to repay it. The court concluded that the taxpayer never intended to repay the sums and that the purported loans were shams.

A number of decisions suggest an opposing view that circumvents economic realities and indicates that the legal form of a transaction should determine whether the recipient of money must include it in his gross income. According to this view, the loan agreement is not pierced to determine whether it is bona fide—that is, whether both parties intended the transaction to be a loan. In *In re Diversified Brokers Co.,*[58] the taxpayer was a corporation, the primary purpose of which had been to borrow large sums of money and to make substantial dividend payments to its shareholders out of the proceeds. Because of the high interest rates at which the money was borrowed, the corporation would have been unable to repay the money even if it had not distributed dividends.

55. *See* text accompanying notes 42-51 *supra.*
56. 384 F.2d 748 (5th Cir. 1967), *cert. denied,* 390 U.S. 946 (1968).
57. 29 T.C.M. (CCH) 1505 (1970), *aff'd per curiam,* 462 F.2d 462 (3d Cir. 1972).
58. 487 F.2d 355 (8th Cir. 1973).

The loans were obtained by fraudulent statements and promises, but, in order to encourage new lenders to part with their money, the corporation promptly paid all loans due up until the moment it went bankrupt.[59]

Other cases dealing with fraudulent corporate loan schemes had held that the loan proceeds were income In *In re Home & Mortgage Corp.*,[60] for example, a federal district court found that fraud in the acquisition of a loan together with the debtor corporation's inability to repay proved that the corporation never intended to make good on the loans. The bankrupt corporation was therefore "deemed not to have incurred any obligation to repay and [was] taxed on the economic benefits realized from the transaction."[61]

Despite these precedents, the Eighth Circuit found for the taxpayer in *In re Diversified Brokers Co.* The court gave two reasons for its ruling. First, the transactions satisfied the requirement of consensual recognition; second, the corporation had received no benefit from the loans.[62]

The court, looking at the bona fides of the transaction, stressed that both the borrower and the lenders had at all times treated the transactions as loans, and that some money had been repaid.[63] The court reached its decision despite findings that the borrower could not possibly repay all the loans, and that the corporation had made no effort to use the loan proceeds in a way which conceivably could have increased its ability to repay—thus, there could be no doubt that the principal officers and shareholders of the corporation intended never to repay all the loans.

Ignoring intent, the court of appeals relied on the district court's finding that the corporation considered the transactions to be loans. The appellate court divorced the intent of the officers and shareholders from that of their corporation. The court looked to the independent legal existence of the corporation and to the

---

59. *Id.*

60. *In re* Home & Mtge. Corp., No. B-189-167 (D.N.J. 1971), *cited in In re* Diversified Brokers Co., 355 F. Supp. 76, 86 (E.D. Mo. 1973).

61. *Quoted in Diversified,* 355 F. Supp. at 89. *See also* United States v. Rosenthal, 470 F.2d 837 (2d Cir. 1972). The court upheld a conviction for corporate tax evasion on similar facts. The defendant did not contest the trial court's finding of tax liability, but appealed on different grounds.

62. 487 F.2d at 358. For discussion of the court's benefit analysis, see text accompanying notes 67-72 *infra.*

63. The decision was 2 to 1. Judge Heaney wrote the opinion of the court, and Judge Ross concurred in a separate opinion.

legal form of its obligation in order to divine corporate intent, disregarding the intent of all the people who together constituted the corporation.[64]

Judge Ross, in his concurring opinion, admitted that under *James* the money received "could be considered income to the bankrupt corporation."[65] *James,* he noted, did not deal with the issue of whether the government should take the bankrupt corporation's assets at the victim's expense, and, therefore, was not controlling.[66] Although such equitable considerations often influence the courts,[67] the priority of government claims over those of other creditors really has nothing to do with the question of whether an item should be included in income.[68]

---

64. The court scrutinized carefully the formal aspects of the transaction, as well as the negotiations and other dealings between the lenders and the corporation, in order to ascertain the corporation's intent. Disregarding all those factors which showed a fraudulent scheme, the court concluded that everyone involved had treated the transactions as loans. It can be presumed, however, that if the scheme had been discovered before the corporation went into bankruptcy, the lenders would very quickly have demanded repayment. The lenders' consent was obtained by fraud; true mutuality was lacking.

This analysis was not followed by the Tenth Circuit in United States v. Swallow, 511 F.2d 514 (10th Cir.), *cert. denied,* 423 U.S. 845 (1975), involving facts similar to *Diversified. Swallow* erroneously distinguished *Diversified* on the ground that the loans in *Swallow* were obtained in bad faith. The *Diversified* court, however, would have considered it important that the corporation in *Swallow* did use some of the borrowed money for corporate purposes. For further discussion, see notes 69-96 *infra* & accompanying text.

65. 487 F.2d at 359 (Ross, J., concurring).

66. The majority in *James* must have been aware of this issue, however, because it was specifically mentioned in a dissenting opinion. 366 U.S. at 227-29 (Black, J., concurring in part, dissenting in part).

67. An example is Scudder v. Commissioner, 405 F.2d 222, *rehearing denied,* 410 F.2d 686 (6th Cir. 1969), *rev'g* 48 T.C. 36 (1967). The husband of a member of a partnership had misappropriated money from the partnership. The Commissioner attempted to enforce the tax deficiency against the wrongdoer's spouse as co-maker of the joint return. The Tax Court held in favor of the Commissioner. 48 T.C. 36 (1967). Appalled at this result, the Sixth Circuit reversed the Tax Court, holding first that the receipt was an unauthorized loan which was not income, 405 F.2d at 227, and second, on motion for rehearing, that even if the funds had been embezzled, *James* did not reach these facts, 410 F.2d at 690. Congress wisely responded to the Tax Court decision, not by modifying *James,* but with I.R.C. § 6013(e), which protects a spouse who is both unaware of the other spouse's income and does not benefit from it. Clearly it is preferable for courts to be forced by statute to consider equitable principles in all these cases rather than for the courts to be free to continue to rely on concepts of fairness only in isolated cases.

68. The problem of enforcement of income tax deficiencies against bankrupts is often the true reason that courts shy away from strict application of the *James* doctrine. Income tax due but not paid on demand "shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person." I.R.C. § 6321. Such a lien is satisfied before the interests of other creditors are considered, except as follows:

> The lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until

IV. The Concept of Gain in James

As has been seen,[69] *James* established a two-step procedure for determining whether it is appropriate to tax a party. First, the taxpayer's control over the money is examined without regard to its lawfulness. Second, the circumstances of the transaction are reviewed to determine if the parties intended the transaction to be a loan. If the parties so intended, the recipient need not pay tax on the money regardless of his control over it.

The trial court in *Diversified*[70] cited *Rochelle's* summary of *Wilcox, Rutkin,* and *James* as a proper explication of the first step of the *James* analysis:

> [T]he Supreme Court has now finally concluded that the *economic benefit* accruing to a taxpayer from the receipt of money is the controlling factor in determining whether the receipt is "income."[71]

James, properly interpreted, *did* attempt to bring income tax theory into harmony with economic realities. Both the trial and appellate courts in *Diversified* concluded, however, that receipt is not prima facie proof of income, even if both consensual recognition and substantial restriction on use of the money are absent.

> notice thereof which meets the requirements of subsection (f) has been filed by the Secretary or his delegate.

I.R.C. § 6323(a).

State law governs the taxpayer's property interest in his gains. Acquilino v. United States, 363 U.S. 509 (1960). If the victim of an embezzlement can perform the almost impossible task of tracing the movement of his property while it is still in the hands of the embezzler, the government's lien cannot attach to it. On the other hand, an extortionist has a voidable title in his misappropriations, so a lien can attach. *See* Rutkin v. United States, 343 U.S. 130 (1952). Also, a taxpayer who has obtained loans fraudulently has an interest to which the lien can attach. *See* United States v. Rochelle, 384 F.2d 748 (5th Cir. 1967). Therefore, the government takes the wrongdoer's assets before the victim's claim is considered, unless the victim can win the race to the courthouse and become a judgment creditor before the government accomplishes the one prerequisite to its recovery—notification in the prescribed manner.

Confusion over whether an item is income or property to which a lien can attach is not uncommon. An example is the way in which *Rutkin* distinguished *Wilcox,* invoking a rationale the Supreme Court subsequently rejected in *James. See* text accompanying note 16 *supra.* But whatever the conclusion, misappropriated funds can also be used to satisfy other claims the government might have. This is Congress' design, and a court will not even consider other valid governmental purposes. *See* Campbell v. Campbell, 88 N.J. Super. 63, 210 A.2d 644 (1965) (levy on alimony payments upheld even though the former wife—the taxpayer—and her child, deprived of the alimony, would be forced to go on welfare).

69. *See* text accompanying note 23 *supra.*

70. *In re* Diversified Brokers Co., 355 F. Supp. 76 (E.D. Mo.), *aff'd,* 487 F.2d 355 (8th Cir. 1973).

71. 355 F. Supp. at 85 (paraphrasing United States v. Rochelle, 384 U.S. at 751).

One who receives money must benefit from the receipt if he is to be taxed on it.[72] The court of appeals found that the money received did not benefit the corporation, but only its shareholders, and concluded that the corporation need not include the money in its gross income. In denying that the corporation's receipt of the funds, by itself, was sufficient to subject the corporation to taxation, the court violated the general rule that a corporation is taxed on its gains whether or not they are distributed to its shareholders.[73] Further, the corporation did benefit by having the *ability* to distribute earnings to its shareholders.[74]

This narrow and distorted reading of *James* has not been followed.[75] Other courts have found support in *James* for the broader proposition that a person's control over the disposition of funds provides adequate justification for taxing him even when he has not actually received the funds. In *Gradsky v. Commissioner*,[76] a corporation owned by the taxpayer obtained loans fraudulently, with no intention of repaying them. The money was dispersed by the corporation to the taxpayer's business and to others controlled by his family. The taxpayer's argument was that neither he nor the recipient corporation benefited from the portion of the money that went into other businesses in which he had no interest. The court rejected this view and found that the taxpayer "had such command, control, and dominion over these funds . . . that as a practical matter, he realized economic gain and benefit."[77]

Other courts, going further than *Gradsky*, have concluded that direct benefit—benefit from the money itself—is not the *sine qua non* of income. In *Bailey v. Commissioner*,[78] the taxpayer embezzled money from a bank by falsifying the books to show deposits in her brother's account. The brother withdrew the funds

---

72. 487 F.2d at 358; 355 F. Supp. at 85.

73. *See* National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949); Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943). Exceptions to this rule derive from specific statutory exemptions. The *Diversified* court may have had in mind the subchapter S corporation for which, if certain conditions are met and all profits are included in its shareholders' income, there will be no corporate liability for taxes. *See* I.R.C. §§ 1371-1379. This exception to the general rule permits small numbers of investors to enjoy the advantage of the corporate form without its additional tax liability.

74. The distinction the court made between direct consumption and conferral of the right to consume on another has, in another context, been condemned by the Supreme Court. *See* Lucas v. Earl, 281 U.S. 111 (1930).

75. United States v. Swallow, 511 F.2d 514 (10th Cir. 1975), *cert. denied*, 423 U.S. 845 (1975).

76. 29 T.C.M. (CCH) 625 (1970).

77. *Id.* at 635.

78. 52 T.C. 115, *aff'd*, 420 F.2d 777 (5th Cir. 1969).

and spent them on himself. In reply to the taxpayer's contention that she neither received nor benefited from the money, the Tax Court quoted from a previous case:

> "That may be one way to describe it [the transaction]. Another, equally valid, is that the funds came to * * * (the embezzler) and were passed out or made available by her to the beneficiaries. These beneficiaries were the objects of * * * (the embezzler's) bounty, not the bank's. She was the force and fulcrum which made those benefits possible. She assumed unto herself actual command over the funds. This is enough."[79]

The court refused to rely either on the unlawfulness of direct receipt of the funds by the taxpayer, or on the fact that she did not directly benefit from the use of the funds. The court implied, however, that the taxpayer actually benefited from having the power to confer economic gain on others of her own choosing. Thus, underlying the court's determination is the notion that the taxpayer both generated and controlled the disposition of the gain.

Bailey ignored a prior Tax Court case that suggests a different result. In *Teschner v. Commissioner*,[80] the taxpayer entered a contest that required participants over a certain age to choose a person under that age to be the recipient of the prize. The taxpayer had picked his daughter. The Tax Court found that since the taxpayer had no right to receive the prize himself, the prize was not income to him.

In *Commissioner v. First Security Bank of Utah, N.A.*,[81] *Bailey's* interpretation of *James* was indirectly questioned by the Supreme Court, which chose instead to follow the tradition of *Teschner*. Here, a bank and an insurance company, both of which were wholly owned subsidiaries of one holding company, had been involved in the sale of insurance policies to the bank's customers. When a customer of the bank wanted insurance on a loan, the bank completed all of the required forms and collected the premiums. It forwarded the forms and payments to the insurance company, which assumed the entire risk of the insurance. The insurance company included the premiums in its own corporate income tax return. Using section 482, the Commissioner attempted

---

79. *Id.* at 119 (quoting Estate of Geiger v. Commissioner, 352 F.2d 221, 231-32 (8th Cir. 1965), *cert. denied*, 382 U.S. 1012 (1966)).
80. 38 T.C. 1003 (1962).
81. 405 U.S. 394 (1972).

to reallocate some of the income from the insurance company to the bank.[82]

The Court found that it was usual business practice for the insurance company to pay a sales commission, amounting to between 40 and 55 percent of the net premiums it received, to anyone who sold its policies.[83] In this case the bank sold the policies, received the proceeds, and disposed of the income to a party of its choosing—the affiliated insurance corporation. Nevertheless, the Supreme Court held that the commissions were not taxable to the bank, because under federal law it was illegal for a national bank to profit from the sale of insurance to its customers.[84]

The *Utah* Court first decided that generation of income alone was not sufficient to impose taxation.[85] This must be true; otherwise, an employee who generates far more income in the course of his employment than he is paid would pay tax on all that he generates, even though he has traded his capacity to generate income for the highest price he can get and can never actually earn the amount of income he generates. Logic requires that the employee control the disposition of money before he can be taxed on it. In assessing what degree of control over the funds should give rise to tax liability under both section 482 and section 61, the majority of the Court found it necessary to apply an assumption that appears in the regulations under section 482[86]—"com-

82. I.R.C. § 482 gives the Commissioner the power to reallocate income and deductions among affiliated organizations if necessary in order "to prevent evasion of taxes or clearly to reflect the income of any such organizations . . . ."

The Commissioner wanted to reallocate the income because life insurance corporations are taxed at an effectively lower rate than banks. *See* I.R.C. §§ 801-802.

83. 405 U.S. at 397. Further, the facts disclosed that even before the holding com pany formed its own separate insurance company to take over the insurance from independent insurance companies, one of the holding company's subsidiaries, Ed. D. Smith & Sons, had received the commissions from the independent carriers although the subsidiary had no other relation to this particular insurance business. 436 F.2d at 1194.

84. 405 U.S. at 401-02.

85. In *Utah*, the Court directly opposed the generation of income theory, which had been the foundation of *Bailey*, decided under *James*, and had been followed by both the Tax Court in *Utah*, 26 T.C.M. (CCH) 1320 (1967), *rev'd*, 436 F.2d 1192 (10th Cir. 1971), *aff'd*, 405 U.S. 394 (1972), and the Seventh Circuit in Local Fin. Corp. v. Commissioner, 407 F.2d 629 (7th Cir.), *cert. denied*, 397 U.S. 956 (1969). Under the generation of income doctrine, a taxpayer who designates an entity to perform services and exercises control over that entity is taxable on income produced by such services. The generation of income doctrine has been described as a corollary of the assignment of income doctrine. Both look to *who* controls the income. The assignment of income doctrine focuses on the power to dispose of income, while the generation of income doctrine focuses on the power to create income.

86. 405 U.S. at 398. Complete power is mentioned as an assumption in Treas. Reg. § 1.482-1 (b) (1968). *Utah* is the first to employ it in determining whether income exists under I.R.C. § 61.

plete power" of the taxpayer over the funds—as a prerequisite to taxation.[87] The Court held that only complete freedom of the holding company to "shift income among its subsidiaries"[88] could justify taxing the bank for the commissions it earned but did not receive. The Court concluded:

> It is only where this power exists, and has been exercised in such a way that the "true taxable income" of a subsidiary has been understated, that the Commissioner is authorized to reallocate under § 482. But [the parent corporation] had no such power unless it acted in violation of federal banking laws. The "complete power" referred to in the regulations hardly includes the power to force a subsidiary to violate the law.[89]

Justice Blackmun, in dissent,[90] attacked the majority's definition of control and its restrictive view of income. He claimed that section 482 was "designed to produce for tax purposes, and to recognize, economic realities and to have the tax consequences follow those realities and not some structured unrealities."[91]

Utah, if not properly limited to its facts, may weaken the authority of *James* as precedent for the principle of ignoring legal formalities in favor of economic realities. The insurance company in *Utah* would not have earned the premiums without the efforts of the bank; rather than accept the commissions customarily paid for this work, the bank simply transferred them to another branch of the corporate group. Thus, the bank both generated the com-

---

87. An examination of the purposes of section 482 sheds some light on the effect of the Court's interpretation. First, section 482 is an amalgam of several important tax theories, "tax avoidance principles, assignment-of-income notions, general deduction theories, and clear reflection of income under the parties' accounting methods." B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 15.06. Second, section 482 can be used by the Commissioner to create income in a situation where normally there would be none. *See* Commissioner v. B. Forman Co., 453 F.2d 1144 (2d Cir.), *cert. denied,* 407 U.S. 934, *rehearing denied,* 409 U.S. 899 (1972); Loening, *Section 482 Allocations Resulting in the Creation of Income or in Constructive Dividends to Shareholders,* 30 N.Y.U. INST. ON FED. TAX 1247 (1972). Creation of income is illustrated in *Forman,* where corporation *X* lent money to an affiliate corporation *Y* at no interest. The Second Circuit included a five-percent interest payment (though never made) in *X's* income, and gave *Y* a comparable deduction. The court found this outcome required even if *Y,* the borrower, had not made a profit on the loan. Ordinarily, under assignment of income principles a party is taxable only on gain. The assumption or requirement of "complete power" in the context of section 482 may suggest that a greater degree of control is necessary to create income in the affiliated corporation setting. This quantum of control should not be required for normal income taxation under section 61.

88. 405 U.S. at 401.

89. *Id.* at 404-05.

90. *Id.* at 418 (Blackmun, J., dissenting).

91. *Id.* at 419.

missions and controlled their disposition. Only extreme attention to a legal formality—the illegality of retaining the commissions—prevented the determination that this money was income to the bank.

The doctrine of complete power may, however, be short lived; this restrictive approach was not used by the Supreme Court in a later case, *United States v. Basye*.[92] A medical partnership, Permanente, had contracted with a corporation, Kaiser, to provide services to Kaiser's members. As partial payment for the medical services provided by Permanente, Kaiser established a retirement trust for Permanente's partners and certain of its individual employees. The Court held that Permanente and its individual partners were taxable at the time money was contributed to the trust, even though it was impossible to tell then whether any of the individual partners would ever actually receive any of the money. It was clear, however, that the money was forever lost to Kaiser.

The Court did not disturb the trial court's factual finding that Kaiser was unwilling to make any other direct payments to the partners, so "Permanente could not have received that income except in the form in which it was received."[93] The Court determined that once the government showed that Permanente had earned the money, it "need not prove that the taxpayer had complete and unrestricted power to designate the manner and form in which this income is received."[94]

Utah had expressed the view that the taxpayer must have complete power to receive commissions in order to be taxed on them. In *Basye*, strict application of this view would have permitted Permanente to escape immediate taxation. But since the facts of the two cases are not directly parallel, it is not clear what degree of control the Supreme Court in the future will deem necessary to justify imposition of income tax liability.[95]

---

92. 410 U.S. 441 (1973). The court of appeals in *Utah*, in concluding that the bank was not taxable, looked not only to *Teschner*, *see* text accompanying note 80 *supra*, but also to the district court decision in Basye v. United States, 295 F. Supp. 1289 (N.D. Cal. 1968), *aff'd*, 450 F.2d 109 (9th Cir. 1971), *rev'd*, 410 U.S. 441 (1973), which held that the partners were not taxable. 436 F.2d at 1197.

93. 410 U.S. at 451.

94. *Id.* at 452.

95. There is one way to challenbe *Basye* without questioning its broad approach to income taxation. Section 83 provides:

> If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, . . . [the profit] shall be included in the gross income of the person who performed

Similarly, the Court's treatment of income in *Basye* does not directly address the extent of *Utah's* influence on *James*. The Supreme Court in *Utah* stated that it left intact *James* and, presumably, *Commissioner v. Bailey*. *Utah* sought to distinguish *James* by saying that in *James* "the illegality involved was the act which gave rise to the income."[96]

James held that an embezzler has enough control over his illegal gains so that they may properly be treated as taxable income, although he has a legal duty to repay them. *Bailey* took *James* one step further by finding that the fact that the embezzler did not receive the funds himself will not, in itself, disturb the notion of the embezzler's control over the funds.

Utah found that in order to impose taxation, "complete power" or complete control over the funds must exist; the bank's inability legally to receive the commissions deprived the bank of this "complete power," preventing taxation.[97] It is too simplistic to conclude that *Utah* was wrongly decided because it ignored the *James* determination that the legality or illegality of receipts should not be a factor in assessing taxation. What *James* did say was that the legal obligation to repay is, by itself, merely a formal factor with little practical reality. A similar analysis in *Utah* would have led to the conclusion that the legal inability to receive the commissions had, in the bank's situation, little practical effect because the bank controlled the disposition of the funds.

Basye, on the other hand, has revived the *James* notion that a taxpayer may be taxed on gains even if his control over them is not complete. All factors in an individual case must be examined in order to determine the practical degree of control a

---

> such services in the first taxable year in which the rights of the person having the beneficial interest in such property . . . are not subject to a substantial risk of forfeiture . . . .

I.R.C. § 83 (a). Substantial risk of forfeiture is defined as follows:

> The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.

I.R.C. § 83 (c) (1). Certainly, Permanente's partners had a contingent right that would be forfeited if they did not continue to serve Kaiser. Of course, if section 83 had been applied, Kaiser would have been forced to postpone its deduction until each partner had been taxed. *See* I.R.C. § 83 (h).

The fact that the case dealt with partners and not with regular employees can be used to justify the Court's opinion, section 83 notwithstanding. The majority of the partners, as a group, could have terminated the entire trust and received their share of the money. Their power to do this may have prevented the application of section 83.

96. 405 U.S. at 405.

97. *See* text accompanying notes 81-89 *supra*.

taxpayer has over funds. In *Basye,* the partners who were taxed had only limited control over the funds, and *Basye* is therefore difficult in this respect to reconcile with *Utah,* where the bank's control over the commissions, although they were not received, was fairly extensive. Though *Basye* provides a clue in assessing the degree of control necessary to impose taxation, it appears that in practice taxation under the generation of income theory will depend on certain factual distinctions.

A comparison of *Utah, Teschner,* and *Bailey,* however, reveals the application of a consistent theory of taxation. But for the efforts of the taxpayers in generating the income, there would have been no benefit for them to confer on others. In *Utah* and *Teschner,* the taxpayers were not taxed, but the taxpayer in *Bailey* was. *Utah* and *Teschner* concluded that to have taxable gain, the taxpayer whose efforts economically benefit others must voluntarily relinquish the right to receive the money. Under this view, *Bailey,* of course can be reconciled with *Utah* and *Teschner* because the taxpayer could just as easily have embezzled the money for herself as for her brother.

These three cases do, then, offer a rational basis for deciding whether or not a taxpayer who assigns income to another should be taxed: only the taxpayer who voluntarily chooses not to receive the income is subject to taxation. *Bayse,* however, suggests that less than complete power may justify taxation. The taxpayers in *Basye* voluntarily generated income knowing the form in which it would be received. Their decision to accept a special indirect form of payment for their services was held to permit taxation. Similarly, in *Utah, Teschner,* and *Bailey* the taxpayers voluntarily generated income and conferred it on parties of their own choosing. Certainly, courts can in fairness rely on such voluntary choices to determine that a taxpayer has had gain.

CONCLUSION

Under section 61 of the Internal Revenue Code, Congress, with certain statutory exceptions, has delegated to the courts the duty to define the scope of income. Using the traditional broad construction of section 61, *James* formulated a test of income that accords with economic realities. For the most part, the courts have zealously limited the exceptions to this formulation.

Utah did not overrule *James,* but merely distinguished it and, in so doing, left it free to operate in the field of wrongful appropriations. It is not clear, however, whether *Utah* will restrict *James'* broader conclusion that the practical effect of economic activity is determinative of income taxation. The *Basye* decision is the clearest indication that the spirit of *James* is still alive.

WILLIAM B. BARKER